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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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JAN 27 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	**MM Docket No. 92-266**
	)	
Rate Regulation	)	

COMMENTS OF DISCOVERY COMMUNICATIONS, INC.

Judith A. McHale
Senior Vice President and
General Counsel
Barbara S. Wellbery
Vice President and
Deputy General Counsel

DISCOVERY COMMUNICATIONS, INC.
5500 Wisconsin Avenue
Bethesda, MD 20814

Richard E. Wiley
Philip V. Permut
Lawrence W. Secrest, III
William B. Baker

WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 429-7000

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SUMMARY

Discovery Communications, Inc., as the owner of The Discovery Channel and The Learning Channel, will be directly affected by the manner in which the Commission implements the rate regulation provisions of the Cable Television Consumer Protection and Competition Act of 1992.

Congress' purpose in enacting the Cable Act was to promote the availability to the public of a diversity of cable services at reasonable prices, using regulation only where effective competition does not exist. Discovery submits that the FCC should regulate cable rates only where necessary and in a minimally intrusive manner that is fully sensitive to the First Amendment freedoms of the cable industry.

To the extent the FCC finds rate regulation necessary, it should, regardless of the type of regulation it adopts, ensure that cable operators are able to recover all of their costs, including a reasonable profit or cost-of-capital. If the FCC chooses benchmark regulation, cable operators should be able automatically to flow-through their net increased costs for programming and system improvements in order to avoid the disincentives inherent in such a system. The Commission should also allow cable operators to recover the costs caused by particular service tiers from subscribers to those tiers. Furthermore, the regulatory program must allow cable operators and programmers the flexibility to promote their services through creative packaging and promotional offers.

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COMMENTS OF DISCOVERY COMMUNICATIONS, INC.

Discovery Communications, Inc. ("Discovery"), by its attorneys, hereby submits its comments on the Commission's *Notice of Proposed Rulemaking*[1] to implement the rate regulation provisions of the Cable Television Consumer Protection and Competition Act of 1992 ("Cable Act").[2]

I. INTRODUCTION.

Discovery owns and operates The Discovery Channel and The Learning Channel. The Discovery Channel was founded in 1985 to reach an audience not adequately served by existing over-the-air broadcasters. The Discovery Channel features

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1 FCC 92-544 (released Dec. 24, 1992) (*"Notice"*), *summary published,* 58 *Fed. Reg.* 48 (Jan. 4, 1993).

2 Discovery has challenged the constitutionality of various portions of the Cable Act, including the provisions involved in this docket. *See Discovery Communications, Inc. v. United States*, C.A. No. 92-2558 (filed Nov. 12, 1992). This submission is made without prejudice to Discovery's position in that lawsuit. *See Nixon v. Administrator of General Services Administration*, 433 U.S. 425 (1977).

nonfiction documentaries about science, nature, technology, human events, and history. The Discovery Channel now reaches about 59 million subscribers and is one of the most enjoyed and appreciated cable networks in the country.

Discovery acquired The Learning Channel in 1991 and is continuing to upgrade its programming. It features educational programs on subjects such as history, science, archeology, and anthropology for viewers of all ages. It also provides six hours of commercial-free educational programming for preschoolers every weekday morning. Discovery's mission for both channels is to use the power of television to educate and entertain viewers.

As a provider of video programming, Discovery has a vital interest in how the Commission implements the rate regulation provisions of the 1992 Cable Act. The rules adopted in this proceeding will affect not only the price of programming to cable subscribers, but also whether consumers will have access to the wide diversity of programming choices the Cable Act envisions.

In this regard, the Commission should ensure that rate regulation does not stifle innovation in cable services, intrude upon First Amendment speech, or prevent the video programming industry from meeting future consumer needs. As the Act makes plain, these goals are to be achieved as much as possible by relying on marketplace forces.

II. THE COMMISSION SHOULD REGULATE NARROWLY TO MINIMIZE INTRUSION ON PROTECTED SPEECH AND MAXIMIZE THE ROLE OF FREE MARKET FORCES IN PROMOTING PROGRAMMING DIVERSITY AND CONSUMER WELFARE.

While the Commission inevitably will draw on its substantial regulatory experience with the telecommunications industry in fashioning a regulatory program for cable, in doing so, it should remember that cable is *not* a common carrier, but a fully protected First Amendment medium. The type of regulatory discretion that might be appropriate for other industries may well be unconstitutional with respect to cable because of the risk of distortion of free expression. Crafting regulations in the extremely sensitive area of cable rates requires careful reference to constitutional limits. Therefore, the Commission should strive to avoid becoming excessively entangled with First Amendment speakers or regulating more broadly than necessary to achieve the Cable Act's goals.

Congress directed the Commission to avoid undue entanglement and overbroad regulation by stating that the "policy" of the Cable Act is to "rely on the marketplace, to the maximum extent feasible, to achieve . . . availability" of a diversity of views and information.[3] The First

[3] Cable Act, § 2(b). This reliance is well placed. The pricing flexibility that cable systems have had since deregulation has significantly contributed to the present wealth of programming enjoyed by cable consumers.

Amendment condemns not only censorship, but any entanglement of government and media that might improperly impede free expression.[4]

Consistent with this approach, the FCC should establish standards that find "effective competition" whenever feasible. In that regard, Discovery respectfully submits that the Commission define the term "multichannel video programming distributor" as broadly as possible; measure penetration for purposes of the statute's second test for "effective competition" cumulatively, *i.e.*, by adding the subscribership of all alternative multichannel video programming distributors; and establish a presumption that putative competitors offer "comparable video programming."[5] Defining "effective competition" in this manner will minimize regulatory entanglement with First Amendment speakers.

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4 *See Miami Herald Publishing Co. v. Tornillo*, 418 U.S. 241 (1974) (government cannot target media operations for regulation, even if purpose is benign); T. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 Yale J. on Reg. 65, 117 (1990) ("[W]hile much frivolous, misleading, and antisocial speech, not to mention socially wasteful press duplication, theoretically could be eliminated by pro-consumer [cable] regulation, the cost would entail entrusting large blocks of discretionary authority to political agents. In this context, market power . . . possessed by a private unregulated supplier of news and entertainment services is judged less harmful than the alternative: monopoly power by regulators as buying agents for consumers.").

5 *Notice*, ¶ 9. Discovery agrees with the Commission's provisional decision to expedite proceedings for modification of regulatory status if an operator later becomes subject to "effective competition." *Id*.

III. TO THE EXTENT RATE REGULATION IS NECESSARY, THE COMMISSION SHOULD ENSURE THAT ITS REGULATIONS PRESERVE THE ABILITY OF VIDEO PROGRAMMERS AND CABLE OPERATORS TO PROVIDE TO THE PUBLIC HIGH QUALITY PROGRAMMING AT REASONABLE COSTS.

In establishing a regulatory scheme for cable rates, the Commission must consider a variety of public interests. As the Supreme Court held in *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591, 603 (1943), rate regulation must balance the interest in protecting consumers with the need to allow the regulated entity sufficient revenue, including a return on investment, "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *See also Arrow Transportation Co. v. Southern Railway Co.,* 372 U.S. 658, 664-65 (1963); *American Telephone and Telegraph Co. v. FCC,* 487 F.2d 865 (2d Cir. 1973). The regulatory structure should facilitate pricing freedom with a minimum of compliance costs to avoid chilling the aggressive investment in new technology and programming diversity that has characterized the cable industry since deregulation.[6]

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[6] The *Notice* recognizes that the Commission's actions in this area can affect cable operators' ability "to attract capital necessary to operate and to expand the services they provide to their subscribers." *Notice,* ¶ 94. Thus, the *Notice* solicits comment on "the impact of rate reductions, or of limits on prospective rate increases, on the ability of cable operators to provide service to subscribers on the basic or higher service layers." *Id.,* ¶ 4.

If done properly, the Commission's rate regulation of cable systems can ensure both reasonable rates and continued growth in the quality, availability, and diversity of video programming. To accomplish this, Discovery believes that the Commission's rate regulatory regime, regardless of the form which is adopted, should incorporate the following:

1. Incentives for cable systems to invest in additional capacity and programming;

2. Assurances that consumers pay a fair price for the services they use and that cable operators earn a fair return; and

3. Flexibility for the cable industry, both system operators and programmers, to compete and to attract new customers.

Cable rate regulation guided by these principles will best promote economic efficiency in the cable market, establish adequate incentives for cable operators to expand and improve their systems, avoid excessive rates, and bring diverse video programming to consumers.

A. The Public Interest Requires That Cable Operators Have Adequate Incentives To Expand and Improve the Quality of Their Systems and Programming.

The Commission has tentatively proposed to adopt a form of "benchmark" regulation as the primary means of regulating cable rates, with the use of traditional cost-of-service regulation as an alternative methodology for those systems whose costs are significantly above average.[7] Regardless of the type of regulation adopted, the Commission must be sure to build the proper economic incentives into its regulatory structure, and allow a cable operator to recover all its costs, including those it incurs in expanding its system and obtaining new programming and a reasonable return in capital.[8]

Assuming the Commission ultimately decides to rely primarily on benchmark regulation, it must address the potential economic disincentives inherent in such a scheme. As the *Notice* recognizes, benchmark regulation will create a tendency for rates to "converge" over time to that benchmark.[9] In instances where this occurs, a cable operator would hesitate to increase costs, which it could not simply and readily "recapture." Such higher costs simply would

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[7] Although Discovery expresses no preference for either form of regulation, it believes that the same rate theory should apply to all levels of programming services. Inconsistent regulation of the different levels of service will, inadvertently but inevitably, interfere with fair and full cost recovery.

[8] Cost-of-service regulation, by its very nature, permits recovery of all of a cable operators' costs, including new investments in plant and programming. In light of the cable industry's record of expansion and growth over the past decade, and the likelihood that new video programming services will emerge in the future, fears that costs-of-service regulation would give cable systems little incentive to improve service or make their offerings more attractive to customers appear unwarranted.

[9] *See Notice,* ¶ 37.

reduce its profits or force it to go through an arduous and expensive process to increase rates.

Discovery believes that such a situation would neither serve the public interest nor comport with the purpose of the Cable Act. One way to prevent this problem from developing is to allow cable operators automatically to flow-through their *net* increased costs for programming and system improvements.[10] Allowing such pass-throughs will not artificially discourage cable operators from expanding their capacity, enhancing service quality, and adding new programming if the marketplace will support such actions. Moreover, it would not be a disincentive for cable systems to convert to newer technologies, such as fiber optics, which promise both greater capacity and innovative services.

If the Commission adopts a form of benchmark regulation, it should choose a benchmark that specifically recognizes all legitimate and proper costs. A failure to do so would risk reversing the many benefits achieved by the industry through the substantial increase in investment since deregulation. Discovery respectfully submits that the Commission should consider use of the Capital Asset Pricing Model (CAPM) as a

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[10] Discovery uses "net increased programming costs" to mean the additional costs that an operator incurs to carry its programming. For example, if when the benchmark is set a cable operator's programming costs are $x, but at a certain point in time the cable operator modifies its programmings (*e.g.* drops and adds channels) and its total costs now exceed x by y, the benchmark would automatically increase by y.

means of assessing accurately financial risk as a component of the equity cost of capital.[11] Because cable ventures tend to entail higher-than average risk, the cost of capital is commensurately higher, which should be reflected in any benchmarks. A CAPM-produced equity return is determined in the competitive financial market and should indicate the level of return necessary to compensate equity investors for financial risk and to keep equity flowing to the enterprise. Within the benchmark category, a return similar to the average (over firms in the category) CAPM-produced return should be the relevant equity cost component.

Moreover, if the Commission adopts benchmark regulation, it should do so on a per channel basis. This approach preserves the ability of cable operators to modify their service tiers as consumer demands change over time without economic harms, and avoids creating incentives to evade rate regulation by retiering.

Recognizing the possibility that cable rates will rise over time because of normal economic pressures, the *Notice* asks whether the Commission should adopt a "price cap" scheme

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[11] CAPM was developed by Nobel Laureate William Sharpe. It allows estimation of a company's minimum required equity return as the sum of a risk-free rate of return and a risk premium to compensate equity holders for financial risk. Each company's systematic risk premium is modelled empirically with reference to its own risk (the so-called *beta* factor). Data is available, widely used, and accepted throughout the financial and academic communities.

to govern rate increases.[12] Discovery is concerned that insufficient experience and data exist regarding the cable industry from which a price cap formula can be devised. Unlike the case of the telephone industry, the Commission has available little if any data regarding the cable industry's productivity or the relationship of its costs pressures to price indices.[13] Given this, the chance for harmful error is quite high and Discovery would recommend against the use of a price cap index to limit price increases over time.

In sum, the Commission should assure that cable operators have the opportunity to recover their full costs in system expansion and improvement, and in acquiring programming. Discovery believes that the best way to provide for continued growth and improvement in cable services is to allow operators to recover all costs or automatically to pass through net increases in investment in their systems and programming. In this way, cable operators will not be artificially discouraged from investing in expanding and improving their systems and adding new programming.

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[12] *See Notice,* ¶¶ 37-38, 49-52.

[13] The Commission had long experience with telephone rate regulation before it adopted price caps. This experience provided a wealth of operational history, a solid foundation for understanding telephone company cost behavior, and a basis upon which productivity factors could be calculated.

B. The Public Interest Requires That Each Level of Service Should Recover Its Costs.

The Commission has long recognized that allowing prices of discrete services to recover their costs promotes economic efficiency. The cable industry is no different in this respect from other industries, and the Cable Act does not mandate a departure from this principle. Discovery recommends that, as a matter of policy, the Commission allow cable operators to recover costs caused by particular service tiers from subscribers to those tiers.

The *Notice* correctly recognizes that the cable rate regulation should not create "unintended limits on a cable operator's discretion to tier programming services"[14] or unduly restrict "the ability of cable operators to provide a full range of services on either the basic or higher level service tiers."[15] Regulatory requirements to price certain tiers artificially low would effectively constrain the ability of cable operators to rearrange service offerings to meet consumer demand.[16] This would directly conflict with the Cable Act's intent to allow cable operators and video

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[14] *Notice,* ¶ 32.

[15] *Id.*, ¶ 5.

[16] As noted earlier, adopting "per channel benchmarks" in any benchmark regulatory approach would facilitate the ability of cable operators to rearrange service offerings to meet ever changing consumer demand.

programmers wide discretion in structuring their service offerings.

Furthermore, uneconomic prices for the basic service tier would, in the words of the *Notice*, force "cable systems [to] recover most costs and earn most profits from per channel and per event programming" to recoup revenue "shortfalls" resulting from inefficient, below-cost prices for regulated tiers.[17] Such an approach would not serve the public interest. Requiring customers of pay-per-channels to subsidize other channels would inflict a substantial and unwarranted business cost on pay-per-channel programmers. Moreover, it would inevitably reduce the programming options available to the public.

C. The Public Interest Requires Cable Operators and Programmers To Have Flexibility To Increase the Range of Choices Available to Consumers on Reasonable Terms.

Several issues discussed in the *Notice* raise questions about the flexibility that the cable industry should have to meet the desires of subscribers. These include the promotion and packaging of "a la carte" programming, and the offering of installation and equipment services. The *Notice* recognizes the legislative intent not to impose rate

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[17] *Notice*, ¶ 94.

regulation on channels sold on a pay-per-channel basis.[18] Consistent with that goal, however, the Cable Act does not prevent the cable operator or video programmer, under certain circumstances, from packaging channels also sold on an a la carte basis or granting volume discounts.

There obviously are a number of different ways in which video programmers and cable operators can offer such service packages. Discovery submits that cable systems and programmers should be given the widest possible freedom to promote their products free of regulation as long as such actions do not violate the letter and spirit of the Cable Act.

In this regard, the *Notice* solicits comment on the regulatory treatment of "multiplexed" and "packaged" channels that are also sold separately.[19] As the Commission notes, unregulated a la carte channels do not become subject to regulation simply by being "multiplexed" by the video programmer.[20] Such multiplexing promotes flexibility in service offerings by video programmers, gives consumers the benefit of any efficiencies arising from the combined offering, and is consistent with the Commission's proposal to

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[18] *Id.*, ¶ 95, *citing* House Report at 80.

[19] *Notice,* ¶¶ 95-96.

[20] As used herein, "multiplexing" refers to the offering by a video programmer of commonly-identified channels (*e.g.*, HBO1, HBO2, *etc.*).

exclude pay-per-channel or pay-per-event services offered on a multiplexed or time-shifted basis from the definition of "cable programming." This logic should apply equally to any groupings of channels that are packaged by the video programmer.[21] Certainly, how services are named should not dictate their regulatory status.

Promotional "generic" discounts of pay-per-channel services grouped by the cable operator also should be permitted.[22] These packages give consumers the choice to purchase any and all available programming services, and provide cable operators with a valuable marketing technique designed to increase subscribership.[23] If successful, such promotional offerings can expand the cable operator's

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[21] Such packages could consist of a number of channels that do not share a common name or carry dissimilar programming. One example would be a programming package consisting of a new movie channel and a classic movie channel, each bearing an unrelated name.

[22] An example would be a package allowing a consumer to subscribe to any a la carte service of its choice for $10, any second service of its choice for $8, any third service for $6, and so on. In this situation, consumers are free to pick whichever pay-per-channels they want on an individual basis, receiving greater discounts as they select more services.

[23] In such a situation, if the services also are available on an individual basis, they should not be considered a "tier."

customer base, allowing the operator to gain the revenues necessary to purchase new or better programming.[24]

Finally, promotional offerings by cable operators of specified channels at discounted group rates should be free from regulation if the channels in the package are also available separately.[25] Such "groupings" are a common type of promotion and, as in the case of "generic" packages, advance the public interest by encouraging additional subscribership.

The Commission similarly should encourage the cable industry's efforts to engage in promotional installation and equipment offerings. As the *Notice* recognizes, such promotions contribute to greater cable penetration and are quite common.[26] The congressional intent would not be thwarted by allowing equipment providers to discount their products in order to increase subscriber penetration. The

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[24] The Act's "buy-through" restriction applies only to access to per channel or per program programming. The Act does not prohibit a cable operator from requiring subscribers to purchase one tier of cable programming as a condition for purchasing another tier.

[25] For example, a cable operator might make a promotional offer of HBO and Showtime for a combined rate (*e.g.*, $15) less than the total of their prices when sold separately (*e.g.*, $10 for each). Only if the "grouped" channels are not truly separately available should there be a regulatory concern.

[26] *See Notice*, ¶ 70.

intent of the statute is only to prevent excessive prices for installation and equipment.

Consistent with this goal, the Commission should not allow customers to terminate equipment installment contracts at will.[27] Installment contracts make cable equipment more affordable to consumers that might be unable to make a single, one-time payment. Allowing termination of installment contracts would, in effect, unfairly convert such contracts into leases breakable at the will of the customer. The result would be to discourage equipment sellers from offering installment contracts, and ultimately might reduce consumer benefits.

IV. CONCLUSION.

For the foregoing reasons, Discovery respectfully requests the Commission to the extent possible rely on market forces to achieve the Cable Act's objectives. To the extent that rate regulation, regardless of its form, must be relied upon, Discovery urges that it not artificially and improperly

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[27] *See id.*, ¶ 67.

constrain the video programming industry's ability to meet consumers' needs and desires.

Respectfully submitted,

DISCOVERY COMMUNICATIONS, INC.

By: Philip V. Permut

Richard E. Wiley
Philip V. Permut
Lawrence W. Secrest, III
William B. Baker
WILEY, REIN & FIELDING
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